

# EMPLOYEE OR CONTRACTOR?

## Deciding between an employee or contractor

Contracting has emerged as an alternative to the traditional employment relationship. A contractor can be engaged directly as a natural person, through a trust, partnership or company, or through a labour hire agency.

Sometimes contracting is necessary, where you require specialist skills that cannot easily be obtained by recruiting an employee. Some individuals wish only to be engaged as contractors, particularly where they service multiple clients. Contracting can also prove more cost efficient than employment.

However, there are dangers in engaging an individual as a 'contractor' without having a proper understanding of the law. You may find that the individual is considered to be an employee at law, and this brings with it a range of legal obligations – and liabilities if you get it wrong.

## Do you have a contract in writing?

It is not unusual for a business to engage an individual to perform work and, due to the pressing nature of the work to be performed or a backlog of administrative work, fail to record the terms of the engagement in a written contract. This means that, if there is later a dispute about whether the individual is a contractor or an employee, or there is a dispute about the terms of the contract, there may be significant disagreement between the parties and – ultimately – litigation.

For this reason, it is always prudent to record the terms of engagement in a written contract before the engagement commences, and have both parties sign it. Even if you have already engaged the individual, it is not too late to enter a written contract, and acknowledge that the contract has already commenced.

However, you should be aware that simply calling an individual a 'contractor' on paper, or the fact that they have an Australian Business Number (ABN) or a registered business name, does not mean that this is determinative of the relationship. Courts can still look behind a contract to define the true relationship between the parties. Also, having a contract in place does not mean that you can contract out of your obligations under legislation.

So, what makes an individual an 'employee' or a 'contractor' at law, and how do courts decide?

## Applying the tests

Determining if an individual is an employee or contractor at law, first requires the application of the common law test. Courts have traditionally assessed the relationship against a range of indicia, all of which, when combined, determine the true nature of the relationship.

Even if the common law test determine that an individual is a contractor (at common law), some legislation captures contractors by either:

- (a) deeming them to be 'employees'; or
- (b) treating payments made to contractors the same as (or similar to) payments made to employees.

### Common law test

The common law test for determining whether a relationship is one of independent contract or employment is known as the 'multi-factor' test. This involves identifying and weighing up various features of the relationship to see where the balance lies. This table extracts some common features that courts have considered:

Feature	Employee	Independent contractor
Measure of control exercised by the principal/employer	Employer usually has the right to control how, when and where a worker performs their duties. Tasks are usually performed at request of employer.	Contractor works at own initiative to achieve a stated result. Contractor maintains discretion and flexibility as to how work is completed, although contract may specify some terms as to materials used and methods of performance.
Exclusivity	Employee usually works exclusively for employer.	Contractor is free to provide services to multiple clients.
Right to delegate	Employee is personally engaged to perform the role and has no inherent right to delegate performance of the role to another employee, unless authorised by employer.	Contractor may delegate all, or some, tasks to another person and may employ other persons to perform the services (although this may be subject to the principal's consent).
Risk, rectification of faults	Employee bears little or no responsibility to rectify poor work. Employer is responsible to others for poor work of employee.	Contractor must rectify poor work at own cost and effort, and bears commercial risk of loss incurred by principal due to contractor's poor work.
Tools and equipment	Employee generally performs work using tools and equipment provided by employer, at employer's place of work. Employee is generally reimbursed for expenses personally incurred by them in performing work, as long as they are authorised by the employer.	Contractor generally provides their own tools and equipment. Contractors are not usually reimbursed for expenses they incur in providing the services.

Feature	Employee	Independent contractor
Hours of work	Employee has hours of work set by employer.	Contractor can set their own hours of work, as long as they perform the services.
Leave entitlements	Employee is entitled to annual leave, long service leave and sick leave, and this is usually provided for in written contract.	Contractor is not entitled to leave, and a written contractor agreement would not usually provide for these things.
Payment	Employee is generally paid for their time, e.g. hourly, weekly, annual salary.	Contractor is generally paid for providing services or completing units of work. Contractor usually issues tax invoices.
Method of engagement	Employees are always personally engaged.	If an individual is engaged through a trust, partnership or company, this usually indicates a contractor relationship.
Part of the business	The work of an employee is usually essential to the business carried on by the employer. Employee is working in the business of the employer.	Contractor carries on their own business, independently of the employer and as distinct from the employer's business.

## Legislation that deems individuals to be 'employees'

Some individuals who appear to be contractors can be caught by legislation which deems them to be employees for the purposes of the relevant legislation.

- **Superannuation.** The *Superannuation Guarantee (Administration) Act 1992* (Cth) (**SG Act**) requires you to make superannuation contributions for the benefit of employees. This captures both employees at common law and persons who are captured by the extended definition of 'employee' which is:

*'If a person works under a contract that is wholly or principally for the labour of the person, the person is an employee of the other party to the contract'.*

The purpose of this expanded definition is to reach beyond the traditional employment relationship and capture independent contractors who principally provide their own labour to meet obligations under a contract.

Superannuation Guarantee Ruling SGR 2005/1 explains when an individual is deemed to be an 'employee' under the extended definition in the SG Act. The ATO considers that an individual works under a contract that is 'wholly or principally for the labour of the person' – and is, therefore, a deemed 'employee' - where:

- the individual is remunerated (either wholly or principally) for their personal labour and skills
- the individual must perform the contractual work personally (there is no right of delegation)
- the individual is not paid to achieve a result.

The Ruling specifically notes that an individual who contracts using an ABN may still be an employee for the purposes of the SG Act. However, where an individual performs work for you through an entity such as a company or trust, they are not an employee for the purposes of the SG Act (either at common law or under the extended definition). This is because the company or trust (not the individual) has entered into an agreement

rather than the individual. If you contract with a partnership, then the person who actually does the work is also not your employee. This is so even if the worker is a partner and even if the contract requires the partner to do the work. However, if partners contract outside the partnership in their own personal capacity to provide their labour to fulfil a contractual obligation, they can be your employee.

This extended definition of 'employee' means that, if you engage an individual as a contractor, you may need to pay superannuation contributions for their benefit, even if your written contract with them does not provide for this and even if they use an ABN.

- **Payroll tax.** In most States and Territories, there are now specific contractor provisions which (subject to certain exemptions and concessions) deem payments to contractors to be part of 'taxable wages' which are subject to payroll tax. Available concessions and exemptions should be reviewed in each jurisdiction in which labour performs services. The contractor provisions capture all payments to contractors as part of an employer's taxable wages regardless of whether the contractor is an individual, or is engaged via a company or trust structure.

Western Australia is the only State whose payroll tax act is not harmonised with the other States and Territories on the issue of contractors. Western Australia has not extended its payroll tax system to specifically include payments to contractors. Payments to sole traders who are contractors will only be caught in Western Australia where the persons to whom the payments are made are, 'in substance', employees.

The exemptions recognised in most States and Territories include circumstances where:

- a) the services provided by the contractor are ancillary to the supply of goods under the contract by the contractor (e.g. incidental installation services)
  - b) the services provided by the contractor are of a kind not ordinarily required by you (e.g. an interior decorator hired once a year to select artwork for your reception area)
  - c) the services provided by the contractor are of a kind ordinarily required by you (from any source) for less than 180 days in the financial year
  - d) the services are provided (by the specific contractor) for a period that does not exceed 90 days in the financial year
  - e) the Commissioner is satisfied (which requires reference to relevant rulings and possible input from the Commissioner) the services are performed by a person who ordinarily performs services of that kind to the public generally in the relevant financial year and
  - f) the services are supplied by a contractor if that contractor engages labour to perform the actual services required under the contract – where there must be at least two individuals performing the work
  - g) the services provided are ancillary to the conveyance of goods by means of a vehicle provided by the person conveying them
  - h) the services are in relation to the door to door sale of goods solely for domestic purposes.
- **Workers compensation.** You should be aware that under workers compensation legislation (which is different for each State), you may be required to take out workers compensation insurance for individuals who you engage as contractors. For example, in Queensland, a principal is required to take out workers compensation insurance in respect of any person who is a 'worker', which is defined to include an individual contractor engaged 'for labour only or substantially for labour only'. This will capture most individual contractors.
  - **PAYG withholding.** PAYG withholding generally does not need to be withheld from payments to an individual contractor if the individual is genuinely a contractor. The relevant test for determining whether an individual is an employee for PAYG withholding is the common law test discussed above (i.e. there is nothing in the PAYG legislation that deems genuine contractors to be employees). The position for an individual is not affected by whether or not the individual has supplied an ABN. PAYG does not need to be deducted if you are making

payments to a contracting entity that is a partnership, trust or company, provided that entity quotes an ABN and the arrangement is not a sham or a mere re-direction of an employee's wages.

## Case studies

- A company claimed that a woman who performed office duties, including bookkeeping, was a contractor. The woman's engagement had been terminated, and she sought compensation because she had not been given statutory notice of termination. The company resisted the claim on the basis that she was not an employee, and therefore not entitled to statutory notice. It argued that the woman had no written contract, she issued invoices on a monthly basis via her registered business name, and she operated various other businesses. The Australian Industrial Relations Commission found that she was, in fact, a part-time employee. Some of the factors that influenced that decision were: she did not advertise her bookkeeping duties to the world at large or maintain separate business premises, she worked under the direction of one of the business owners, she did not provide or maintain significant tools or equipment, her work could not be delegated or subcontracted and she was remunerated for hours of work (not completion of tasks). (*Freestone v Morris & Partners Pty Ltd*, [2009] AIRC 223)
- A company who engaged consultants to sell kitchenware products claimed that the consultants were contractors. The consultants would approach members of the public at public venues, such as shopping centres, and invite them to enter a competition to win products. They then contacted the individuals and performed demonstrations of the products with a view to selling them. They signed contracts calling them 'independent agents', which expressly stated that they were not employees. The Federal Circuit Court found them to be employees. It said that their arrangement of work was not consistent with them being independent contractors. For example, the company exercised control in a broad sense over the manner in which they did their work. The consultants had little independent control over how they did their work, particularly the demonstrations. They were an integral part of the company's business. In practice, they could not delegate their work. They were not engaged for a result or a product, but for their labour in following the steps that would produce a result. The company was liable under the sham contracting provisions of the *Fair Work Act 2009* (Cth) and was liable for employee entitlements that should have been paid under the relevant modern award. (*Fair Work Ombudsman v Metro Northern Enterprises Pty Ltd* [2013] FCCA 216)

## Risks: what if you get it wrong?

Generally, the employment relationship is more heavily regulated than a contractor relationship. So, if you incorrectly classify an individual as a contractor, where at law they are in fact an employee, you will find that you are at risk of breaching the law.

If you incorrectly classify an individual as an employee or contractor, you may be liable for:

- superannuation charges, where you have failed to make superannuation contributions for the benefit of the individual either because they are an employee at common law or because they are an 'employee' under the extended definition in the SG Act.
- additional payroll tax (including penalties and interest) where you have incorrectly claimed contractor exemptions on payments made to common law employees (for which there are no exemptions available).
- back pay under a modern award, where you have incorrectly classified an individual as a contractor. Most non-management employees are covered by a modern award and will have entitlements under the award to a minimum wage, overtime, penalty rates, allowances and leave loading. Besides liability for back pay, there are penalties for breaching modern awards.

- unpaid annual and long service leave, where you have incorrectly classified an individual as a contractor. All employees are entitled to paid annual leave, and may be entitled to long service leave upon reaching the required number of years' service.
- compensation for unfair dismissal or for other prohibited conduct. Many employees have access to an unfair dismissal regime, and to other remedies where their employer acts to the detriment of the employee. For example, under the *Fair Work Act 2009* (Cth), an employer must not take adverse action against an employee because the employee makes a complaint about safety matters affecting the employee's employment.

## Further information

- The ATO has information ('Employee or contractor') on its website ([www.ato.gov.au/Business/Employee-or-contractor](http://www.ato.gov.au/Business/Employee-or-contractor)) and also a tick-box tool to help you determine whether an individual is your employee or contractor ([www.ato.gov.au/Calculators-and-tools/Employee-or-contractor](http://www.ato.gov.au/Calculators-and-tools/Employee-or-contractor))
- The Fair Work Ombudsman has information about the differences between independent contractors and employees at <http://www.fairwork.gov.au/employment/independent-contractors/contractor-or-employee/Pages/default.aspx>

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### About the author

CPA Australia commissioned McCullough Robertson Lawyers to supply the content of this *Deciding between an employee or contractor* guide.

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